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Do Your Due Diligence or Pay The Price

BRIAN M. STREICHER

Due diligence and thorough contract negotiating are crucial front-end practices in any commercial transaction and their absence can have severe financial consequences. The latest example of this was apparent in the case of *ISS Action, Inc. v. Tutor Perini Corp.*,[1] involving security services performed by ISS during a runway improvement project at JFK International Airport.

Tutor was hired by the Port Authority of New York and New Jersey to make runway improvements. Tutor hired ISS to perform security services at the construction site. Tutor and ISS entered a preliminary agreement to perform security services at various rates of compensation, which were "subject to New York State sales tax." The preliminary agreement stated that "[t]he parties agree that as soon as they are able they will execute a completed contract subject to [Tutor's] terms and conditions."

ISS began performing security services and sent Tutor an invoice that included a charge for sales tax. Tutor paid the invoice, including the sales tax. Tutor subsequently provided ISS with a Tax Exemption Certificate, which was signed by an employee of Tutor, stating that "[t]he tangible personal property or service[s] being purchased" by Tutor were "exempt from sales and use tax because… [t]he tangible personal property will be used… to improve real property…owned by an organization exempt under

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Termination Clauses and an Inconvenient Omission

KEVIN F. PEARTREE

A contractor is falling down on the job. The owner decides it's time to terminate for cause. But if the owner does not follow its own termination for cause procedure, requiring the opportunity to cure, what should be the consequence?

The short answer is a contractor claim for wrongful termination. The owner's breach of the contract essentially precludes the contractor's performance, including its ability to correct any defects. The wrongfully terminated contractor may recover not only the value of work done to date, but also its lost profits and other resulting expenses.

A contractor alleging wrongful termination has two approaches to damages: it can recover the reasonable value of the work it completed, under a theory of quantum meruit, or it can seek damages based on its total contract price, less payments received and less the contractor's estimate of the anticipated cost of completion. The choice is the contractor's. The owner who wrongfully terminates, in turn, cannot look to the contractor or its surety for the costs of completion. This is a risk to an owner, or contractor, who wrongfully terminates a contractor or subcontractor, whether based on a failure to follow the contract requirements or being wrong about the underlying default.

The danger of a wrongful termination is one reason that owners often include termination for convenience clauses in their agreements that give them a unilateral right to terminate at will. Contractors often include the same right in their subcontracts. This can be useful when the question of default is not clear-cut, or if the relationship between the parties is not working but there has been no default. Typically, these provisions allow the terminated party to recover the cost of work performed to the date of termination, and perhaps costs directly resulting from the premature termination of the work.

As a further hedge against the risk of wrongful termination, owners and contractors often include in their agreements what is known as a conversion clause. If an owner elects to terminate for cause, and it is later found that the owner did not have cause, then the termination automatically becomes one for convenience. With that clause, the owner exchanges the potentially greater wrongful termination damages for the certainty of termination for convenience damages.

But what if an owner wrongfully terminates and there is no conversion clause? That question was addressed in *Black River Plumbing, Heating & A.C., Inc. v. Board of Educ. Thousand Is. Cent. Sch. Dist.*[1], a case in which a school district contracted with a heating contactor to install a pellet boiler system in one of its buildings. During the work, the school district terminated the contract and refused to make the remaining payments. The contractor sued for breach of contract and the school district asserted counterclaims, including the contractor's prior breach.

The court found that by failing to allow the contractor 7 days to cure alleged deficiencies as the contract required, the school district breached the contact and the termination was wrongful. However, the court did not dismiss the school district's counterclaim for damages for payments made to others to correct the contractor's alleged defaults.

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Bidder Responsibility: Heightened Risk for Contractors

NELL M. HURLEY

Public bidding laws require that contracts be awarded to the lowest responsive and responsible bidder. Public owners typically require bidders to submit documentation on work history and financial stability but increasingly also review various databases, sometimes with unexpectedly harsh results. Last year, a New York Appellate Division decision required a contractor to forfeit its $1 million earned contract balance, and a $3 million claim for delay damages, where an online submission concerning administrative agency investigations was later found to be untrue.[1] In addition, by 2019 Executive Order 192, Governor Cuomo pronounced measures that require more scrutiny of bidder responsibility and the public reporting of results on a to-be-developed Office of General Services ("OGS") website database.

Omni Contracting Co., Inc. ("Omni") was awarded a $9 million construction contract for the New York City Housing Authority in 2002. Originally scheduled for 2004 completion, there were delays such that the project was not completed by Omni until 2009. Omni then sued the Housing Authority seeking roughly $1 million in contract balance and $3 million in delay damages. The Housing Authority asserted that Omni had made false representations on its VENDEX (Vendors Information Exchange System) submission prior to the 2002 bid for the contract. Omni responded "no" to questions whether administrative charges were pending against it and whether it was the subject of an investigation, despite two prior prevailing wage violation investigations. The Housing Authority asserted that these false representations induced it to award the contract to Omni.

The Housing Authority moved for summary judgment, arguing that since Omni obtained the contract by fraudulent means, the contract was void as against public policy and therefore Omni could not enforce it. The motion court agreed and dismissed all of Omni's claims, despite the fact that Omni had fully completed the contract. The appellate court affirmed the lower court's decision, finding that the Housing Authority had reviewed Omni's VENDEX submissions which failed to disclose two investigations by the Department of Labor. That court noted:

> ...at a minimum [Omni] should have known that, in determining whether to award it a construction contract [Housing Authority] could review its VENDEX submissions. [Housing Authority] was not required to so inform [Omni].

This decision demonstrates the extent to which courts will go to enforce New York's public policy against fraud in public contracting, despite the general principle that the law abhors forfeiture.

The State is also going to great lengths to prevent contracting fraud administratively. Last year's Executive Order 192 established the Governor's commitment to imposing continuing integrity requirements in state contracts. Among other things, the Order requires that all state contracting entities:

1. Evaluate whether a bidder/contractor is responsible, including whether it has failed to comply with any statutory provision relating to debarment;
2. Upon discovery of information that a bidder/contractor is not or may no longer be responsible, investigate and make a determination as to responsibility;
3. Maintain information on all bidders/contractors deemed non-responsible and submit the information to the OGS, which must post it on its website until a court orders otherwise or a waiver is obtained; and
4. All state entities must rely on a determination made by another state entity as to a bidder/contractor's responsibility. The entity has no discretion to ignore another contracting entity's determination of non-responsibility.

This reliance is required despite an obvious issue: another contracting entity may well use different processes and/or standards in determining a contractor's non-responsibility and have different time periods for debarment. For instance, last spring the Metropolitan Transportation Authority ("MTA") hastily issued debarment regulations imposing an automatic "ten percent rule" (contractor debarred if 10% late or asserts claims of more than 10% of contract value), and prohibiting the MTA from exercising discretion or considering any mitigating factors.[2] Nonetheless, under the Order, a determination of debarment by the MTA must be respected by all other state contracting agencies.

Where does this leave contractors? First and foremost, just like your parents told you, it's always better to tell the truth. Second, assume that any response to a responsibility-related question provided for any bid, for any public entity, can and will be viewed by other public contracting entities, forever. Debarment has always been serious business but the stakes are now higher than ever.

ESD

1 *Omni Contr. Co., Inc. v. New York City Hous. Auth.*, 174 AD3d 447 (1st Dept. 2019).

2 Construction industry and citizen organizations have urged MTA to make changes to this debarment process, culminating in pending lawsuits in both state and federal court. Even so, the regulations are in effect.

CONTINUED "DO YOUR DUE DILIGENCE OR PAY THE PRICE"

section 1116(a) of the Tax Law." Tutor told ISS that, "as a matter of fact and law," it was exempt from paying sales tax on ISS's services, and requested a refund for the sales tax on the first invoice. ISS refunded Tutor.

The parties signed a complete services agreement in 2010 ("2010 Contract") wherein the parties agreed that ISS was responsible for payment of taxes including sales and use taxes. ISS completed the services contract and Tutor timely paid all of ISS's invoices, but ISS never invoiced for sales or use tax.

In 2013, ISS was audited by the state Department of Taxation and Finance and was found to owe $125,000 in back sales and use taxes on the project. ISS then sued Tutor on theories of fraudulent misrepresentation and breach of contract, among others. ISS claimed that Tutor, by representing that it was exempt from paying sales and use taxes for ISS's services, induced ISS to agree to pay for all sales and use taxes, as ISS believed that there would be no taxes to pay. The issue was whether, notwithstanding the contractual provision requiring ISS to pay all sales and use taxes, Tutor's representation and the Tax Exemption Certificate amounted to a fraudulent misrepresentation or a breach of the contract.

Upon Tutor's motion for summary judgment, the lower court dismissed ISS's complaint in its entirety. The appellate court affirmed, holding that Tutor's conduct did not constitute an actionable fraudulent misrepresentation or breach of contract.

The court reasoned that: (1) liability for fraudulent misrepresentation only arises when the allegedly misrepresented fact is in the exclusive knowledge of the party making the representation, and; (2) where a representation has hints of falsity, the recipient is placed in a position of heightened scrutiny. Where that happens, the recipient cannot reasonably rely on the representation without making additional inquiry, said the court. In other words, ISS could not be willfully ignorant by shirking its own due diligence, relying instead on Tutor. The court stated that if a party has the means of knowing, by ordinary diligence, the truth or falsity of a representation, it must make use of those means and cannot complain of being induced to enter the transaction by misrepresentation.

ISS was in the same position as Tutor to discover whether the services that it was rendering were tax exempt, the court said. Moreover, the Tax Exemption Certificate issued by Tutor was, on its face, inapplicable to ISS's work given that ISS was providing security services to Tutor, rather than tangible personal property. According to the court, the facially dubious Tax Exemption Certificate put ISS under a heightened duty of diligence, which ISS did not perform.

The court thus found that any reliance by ISS on the Tax Exemption Certificate or Tutor's representations was unreasonable. The court also found that Tutor did not breach the 2010 Contract, since ISS, not Tutor, was exclusively responsible for all sales and use taxes.

The court's holding and rationale are anchored in two fundamental principles: (1) sophisticated parties must perform their own due diligence; and (2) sophisticated parties are generally bound to contract terms. ISS's failure to heed these principles resulted in an unexpected $125,000 tax burden that it could have passed on to Tutor through proper negotiation. This case is a reminder of the great importance of front-end due diligence and contract negotiation. Never rely on others (particularly the other contracting party) for answers to questions that affect your cost or risk, when you can obtain that information yourself. E&D

1 170 AD3d 686 (2d Dept. 2019).

CONTINUED "TERMINATION CLAUSES AND AN INCONVENIENT OMISSION"

The contractor argued that the wrongful termination automatically converted the "for cause" termination into one for convenience – even though there was no conversion clause in the contract. The court rejected the argument, finding that without a conversion clause, there was no such automatic conversion. Since the termination was for cause, albeit wrongful, the owner may be allowed to recover payments made to third parties to correct the contractor's defaults, said the court.

The fairness of this ruling depends upon the nature of the pre-termination defaults. If the correction costs were incurred before the termination, the owner should be entitled to offset these amounts against a contractor's wrongful termination recovery. If, however, the wrongful termination denied the contractor the ability to correct its defaults at its own expense, why should an owner be entitled to these damages? The court cited a 95 year-old Court of Appeals decision for the proposition that when a termination is for cause, an owner may seek an offset for payments made to third parties to correct a contractor's defaults.[2] But in that case, the alleged defaults pre-dated the termination and could not be cured or corrected at the time of termination. Where the owner, through a wrongful termination, denies a contractor the ability to correct defaults, it should not be entitled to recover those costs, as happened in this case.

While many contractors and subcontractors are skittish about such provisions, the *Black River Plumbing* decision highlights the benefits to them of including a termination for convenience and conversion clause in their construction contracts. E&D

1 175 AD3d 1051 (4th Dept. 2019).

2 *General Supply & Constr. Co. v. Goelet*, 241 NY 28 (1925).

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Ernstrom & Dreste, LLP also publishes the Fidelity and Surety Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

FIRM NEWS

Kevin Peartree and Matt Holmes presented E&D's annual *Construction Law Update* to the Builders Exchange of Rochester in January.

Tim Boldt was named a Board Member of the Greater Rochester Chapter of CFMA.

Tim Boldt and Kevin Peartree attended and were program presenters at the AGC Annual Convention in Las Vegas, Nevada, March 9-12. Mr. Boldt's presentation topic was *"The Art of Negotiating Unfair Subcontracts."* Mr. Peartree's program was titled *"Become the Master of Your Contracts Using the New ConsensusDocs Master Subcontract Agreement."*

Todd Braggins, Brian Streicher and Matt Holmes attended the ABA Fidelity & Surety Law Mid-Winter Conference in New York City, January 29-31. This year's conference added a new construction-specific program to those presented on surety and fidelity issues.

E & D Office Manager Clara Onderdonk was appointed to the Association of Legal Administrators Chapter Resource Team which helps educate members on the policies, programs and initiatives of ALA, including providing support and resources to local chapters.

In May, Kevin Peartree, Tim Boldt and Matt Holmes will present on *"Controlling Risk in Construction and Project Delivery Systems"* to the AGC Future Construction Leaders of New York State at a session in Rochester, New York.